FEDERAL RESERVE BOARD
WASHINGTON

John McKee:

These are the communications I mentioned to you last night. When you have finished with them, please return to the Chairman.

C.C.D.

MSE & Taylor memos

This has been read by Mr. Davis, Mr. Szymczak and Mr. McKee, but has not been seen by Mr. Ransom and Mr. Broderick, who are out of town.

E.T.

ADDRESS OFFICIAL COMMUNICATIONS TO
THE SECRETARY OF STATE
WASHINGTON, D. C.

DEPARTMENT OF STATE
WASHINGTON

August 5, 1937

Dear Marriner:

Thank you for sending me a copy of your memorandum to the President. I shall bring it to the Secretary's attention.

I can appreciate the reasons why the further inflow of foreign capital, even of investment capital, is disturbing to the Federal Reserve System. The State Department hopes the problem can be managed without abrupt or such far-reaching action as to disturb all of our monetary and economic relations with other countries. The suggestion made of banking legislation to increase reserve requirements for foreign deposits combined with a very moderate increase in the withholding rate should, if carried through, act somewhat to deter prospective movements. Therefore I am sorry that the Board has decided

that

The Honorable

Marriner S. Eccles, Chairman,

Board of Governors of the Federal Reserve System,

Washington, D. C.

that the best thing to do is to let the whole matter rest - but this is a personal judgment. A graver situation would be presented if by any chance the conflict in the Far East should so disturb the situation in Europe that the creditor countries of Europe should take over the deposits and security holdings of their nationals and use them to buy war supplies. Germany and Italy have already done that, and I imagine Japan is moving along the same road. The outcome of this would be that we should actually be the owner of all the gold over here instead of merely the warehouse keeper of a very large part of it. Under any such set of circumstances, I suppose our only alternative would be the restriction of the export of goods abroad or the increase of our imports from abroad. We should not want to become the real possessor of almost all the world's gold, for I fear there would be a grave future risk of loss in value.

Sincerely yours,

Herbert Feis

August 2, 1937.

Dear Herbert:

I want to thank you for the memoranda you sent me outlining your case against the tax program for dealing with the gold problem.

I am enclosing a copy of a memorandum which went directly to the President after I had gone over it with Wayne Taylor, who had no objections to it. Considering all the circumstances, it seems to me that the best thing to do is to let the whole matter go over until next January.

Sincerely yours,

Honorable Herbert Feis,
Department of State,
Washington, D. C.

enclosure

ET:b

July 31, 1937.

Dear Wayne:

Attached is a copy of the memorandum for the President which I read to you over the telephone.

Sincerely yours,

Honorable Wayne Taylor,
Treasury Department,
Washington, D. C.

ADDRESS OFFICIAL COMMUNICATIONS TO
THE SECRETARY OF STATE
WASHINGTON, D. C.

DEPARTMENT OF STATE
WASHINGTON

July 31, 1937.

Dear Marriner:

The more I turn over the subject-matter of our discussions in regard to the taxation of non-resident aliens, the more importance the subject seems to acquire. Therefore I felt that I wanted to make my views of record, and I take the liberty of sending you herewith copies of two memoranda I am giving Wayne Taylor this morning.

With best regards,

Sincerely yours,
Herbert Feis

The Honorable
Marriner S. Eccles, Chairman,
Board of Governors of the
Federal Reserve System,
Washington, D. C.

July 31, 1937.

A substantial increase in the present withholding tax on the investments of non-resident aliens would fall most directly on the investments of the people of those countries with whom we have been developing the most close relationships in the economic and monetary sphere, and with whom we are most closely cooperative - e.g., Great Britain, Canada, France, Switzerland, Holland and Belgium. It would affect the interests of many thousands of investors in these countries whose individual holdings are small and of an investment character.

Consequently

(1) It might well affect adversely the future of the tripartite monetary agreement. This is not only because of the potential complaints by those affected, not only because such action would be taken as a sign of the intention to pursue an unnecessarily drastic policy, but also because it would be deemed as new interference with ordinary capital movements. In short, it would weaken the sense on the part of other countries of obligation toward the tripartite agreement.

(2) It might adversely affect the attempts to extend

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the trade agreements program - particularly current negotiations with the United Kingdom.

(3) It would be used to justify action on the part of other countries to levy unjustly heavy taxation against American investments abroad which totaled many billions. The position of this investment in many countries is already much jeopardized.

(4) It would make much less or completely end the possibilities of getting cooperation with the treasuries of other countries in dealing with the problem of tax evasion, both by Americans and by non-resident aliens.

On the other hand, drastic action, affecting adversely important and desirable American interests, is not now necessary to cope with the problems of foreign deposits and essentially speculative foreign operations in this country. Such problems can be handled by more direct means, which have the advantage of avoiding highly undesirable collateral effects. Such action ~~It~~ is not necessary to make reasonably effective banking legislation increasing reserve requirements on foreign deposits.

A very small increase in the withholding rate would indicate the concern of the American Government. The 10 percent rate (which is in addition to other American taxes applied at the source) I believe already corresponds to an income of substantial size.

Weighing these considerations, only action of a very moderate character would be justified; and action of another

character

character might, through its direct and indirect effects, greatly impair the whole effort of international economic and monetary cooperation in which we have been engaged.

Lastly, the line of policy indicated by our discussions with the Canadians would appear to offer a much more satisfactory solution in all respects.

EA:HF:LWW

July 31, 1937.

The position in regard to the tax treaty with Canada is as follows:

The tax treaty with Canada would lower the withholding rate from the present 10 percent to 5 percent.

The Canadian Government has now assured us officially that immediately upon the passage of the treaty it would be willing to enter into continuous discussion with the American Government designed to work out the revision and supplementation of the treaty along the following lines:

(a) The fullest possible cooperation between the two treasuries designed to check evasion, not only by nonresident aliens, but by Americans using private holding companies, etc., on a reciprocal basis.

(b) The revision of the rate whereby the low rate would be retained for the many thousands of Canadian investors who receive a small sum from American investors, and the application of the same tax schedules to the larger Canadian income receivers as though they were Americans - this to be made effective through Treasury cooperation.

The benefits of such an arrangement would be many:

(1) Public opinion would be favorable. The thousands of small investors would pay a suitable rate, while if they

were

were taxed very heavily they would have a sense of injustice. On the other hand, the large investors would pay the American scale.

(2) Government revenues would be increased by the checking of evasion.

(3) A basis will be created by which we could treat with other governments, thereby ending the risks of discrimination and controversy in this field.

The opportunity exists to work along the general lines of the Canadian tax treaty to build up with other countries a series of tax agreements which would supplement the tripartite monetary agreement and our trade program, and at the same time probably produce more revenue.

The contrary course - an abrupt and substantial increase in the withholding tax - would have opposite consequences.

EA:HF:LWW

July 31, 1937.

Memorandum for

THE PRESIDENT

In compliance with the request transmitted to me yesterday by Secretary McIntyre I shall summarize briefly the situation affecting the tax loophole legislation, the taxation of non-resident aliens and the "companion" legislation which would grant to the Federal Reserve Board power to increase reserve requirements on deposit balances maintained in this country by non-resident aliens.

I shall also summarize the positions of the Treasury Department, the Secretary of State and the Federal Reserve Board.

The hearings of the Joint Committee on Tax Avoidance have been concluded except for a final meeting to be held on Tuesday, August 3rd, at 9:30 A. M. At this meeting the Committee's Report will be approved and the only unfinished business, namely, the changes to be recommended in the tax treatment of non-resident aliens, will be agreed upon. The Committee has been informed by representatives of the Treasury that the changes to be recommended by the Treasury at this Session will be simple and that the rate of withholding and other provisions will neither represent too great a variance from the existing 10% withholding rate for individuals nor from the provisions of the Canadian tax treaty, in particular the 5% withholding rate for individuals. Senate action on the Canadian tax treaty has been withheld pending an examination of the tax avoidance situation. The Treasury believes that the exchange of information and the close cooperation between the tax authorities of the countries envisaged by the Canadian Treaty itself and the suggested supplemental working agreements offer a useful method of dealing with alien capital which comes to this country in order to hide from the tax authorities, and that when, as and if similar reciprocal arrangements can be negotiated with other countries the movement of fugitive capital of this character to this country will be discouraged. The Treasury believes that every effort should be made to obtain ratification of the Canadian Tax Treaty at this Session.

The Treasury is confident that a reasonably satisfactory though limited tax loophole bill can be passed at this Session, but that there is little chance for basic revision of the legislation dealing with the taxation of non-resident aliens. In fact an exhaustive study of this subject by the Joint Committee on Tax Avoidance or the full Ways and Means and Senate Finance Committee might well militate against the success of the domestic tax loophole legislation.

The Treasury believes that it should be possible to obtain ratification of the Canadian Tax Treaty, and a moderate increase in the withholding rate for individuals from 10% to 15%.

The Treasury is also prepared to recommend to the Joint Committee an increase in the rate of tax on non-resident foreign corporations on fixed and determinable income from United States cources from the present rate of 10 per cent on dividends and 15 per cent on interest, rents, royalties, annuities, compensation, etc., to a flat rate of $22\frac{1}{2}$ per cent. These taxes are collected by withholding at the source. This rate would be the same as the normal tax rate under existing law on income from United States sources of foreign corporations carrying on a trade or business or having an office or place of business in this country. In order to prevent attempts by foreign corporations to qualify as resident corporations and thereby obtain the benefit of the 85 per cent credit for inter-corporate dividends merely by establishing an office in this country, it will be necessary to include in the above recommendation an amendment to limit the classification of resident foreign corporations to those actually engaged in trade or business here.

The Treasury is also prepared to suggest the elimination of the provision of existing law which exempts from taxation interest paid on foreign bank deposits.

While the Treasury does not feel that these proposals deal with the situation adequately, it is prepared to recommend them to the Joint Committee with the reservation that more comprehensive treatment will be embodied in the general tax revisions which will be presented to the next Session. The present proposals obviously do not differentiate between large and small alien holders of American investments, nor do they take into consideration the existing exemption of non-resident aliens from capital gains taxes, but they will doubtless serve as a significant gesture to non-resident aliens, indicating that this country is not a permanent happy hunting ground for itinerant international speculators.

I shall not attempt to discuss the details of the proposed "companion" legislation which would grant to the Federal Reserve Board power to increase reserve requirements on deposit balances maintained in this country by non-resident aliens. The Treasury believes that this legislation is desirable in itself and represents a definite forward step in the international as well as the domestic credit and monetary fields. It believes that the principle of treating foreign balances on what might be described as a segregated basis should be established as soon as possible.

While the Treasury clearly recognizes the relationship between foreign balances and foreign investments, it is prepared to recommend the banking legislation on its own merits whenever the opportunity is offered.

On June 24, 1937, the Federal Reserve Board adopted the following confidential resolution:

In view of the fact that the gold inflow in recent months has been exceptionally large and may continue, and in view of the further fact that the inactive gold account of the Treasury is now in excess of a billion dollars and the public debt has increased accordingly, the Board feels that the situation impels it to favor legislation granting the Board additional power to absorb excess reserves resulting from additions to the stock of gold by increasing reserve requirements on deposit balances maintained in this country by non-resident aliens.

The Board is of the opinion that the injurious effects upon the domestic economy that would result from an unchecked inflow of gold would be such that the Board and the Treasury should seek a solution of the aspects of the problem which affect the domestic situation.

The Board fully realizes, however, the difficulty of accomplishing the desired ends and considers it essential if the Board is to employ effectively this additional power that:

(a) The Treasury maintain in its inactive gold account approximately the present amount; and

(b) Effective tax legislation be enacted to discourage foreign investment in American securities either through the inflow of new capital or through the use of balances already in this country.

Chairman Eccles and the Federal Reserve Board have reviewed all the factors involved in the existing tax situation and the possibilities for comprehensive legislation at this Session. Chairman Eccles while not opposing the tax recommendations which the Treasury is prepared to make, believes that they will not be of a character to meet the requirements of the Board as outlined in the final paragraph of the confidential resolution and therefore he is opposed to the introduction of the proposed "companion" banking legislation at this Session. Chairman Eccles feels that the relation between the tax treatment of alien investors and the treatment of foreign balances is so close that it is undesirable to alter the treatment of foreign balances if comprehensive and effective tax legislation cannot be enacted simultaneously.

The position of the Secretary of State is as follows:

A substantial increase in the present withholding tax on the investments of non-resident aliens would fall most directly on the investments of the people of those countries with whom we have been developing the most close relationships in the economic and monetary sphere, and with whom we are most closely cooperative - e.g., Great Britain, Canada, France, Switzerland, Holland and Belgium. It would affect the interests of many thousands of investors in these countries whose individual holdings are small and of an investment character.

Consequently

(1) It might well affect adversely the future of the tripartite monetary agreement. This is not only because of the

potential complaints by those affected, not only because such action would be taken as a sign of the intention to pursue an unnecessarily drastic policy, but also because it would be deemed as new interference with ordinary capital movements. In short, it would weaken the sense on the part of other countries of obligation toward the tripartite agreement.

(2) It might adversely affect the attempts to extend the trade agreements program - particularly current negotiations with the United Kingdom.

(3) It would be used to justify action on the part of other countries to levy unjustly heavy taxation against American investments abroad which totaled many billions. The position of this investment in many countries is already much jeopardized.

(4) It would make much less or completely end the possibilities of getting cooperation with the treasuries of other countries in dealing with the problem of tax evasion, both by Americans and by non-resident aliens.

On the other hand, drastic action, affecting adversely important and desirable American interests, is not now necessary to cope with the problems of foreign deposits and essentially speculative foreign operations in this country. Such problems can be handled by more direct means, which have the advantage of avoiding highly undesirable collateral effects. Such action is not necessary to make reasonably effective banking legislation increasing reserve requirements on foreign deposits.

A very small increase in the withholding rate would indicate the concern of the American Government. The 10 percent rate (which is in addition to other American taxes applied at the source) I believe already corresponds to an income of substantial size.

Weighing these considerations, only action of a very moderate character would be justified; and action of another character might, through its direct and indirect effects, greatly impair the whole effort of international economic and monetary cooperation in which we have been engaged.

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The benefits of such an arrangement would be many:

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(2) Government revenues would be increased by the checking of evasion.

(3) A basis will be created by which we could treat with other governments, thereby ending the risks of discrimination and controversy in this field.

The opportunity exists to work along the general lines of the Canadian tax treaty to build up with other countries a series of tax agreements which would supplement the tripartite monetary agreement and our trade program, and at the same time probably produce more revenue.

The contrary course - an abrupt and substantial increase in the withholding tax - would have opposite consequences.

Faithfully yours,

(Signed) Wayne C. Taylor